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TAGS: PREL ECON EINV ETRD PGOV RS
SUBJECT: TFGG01: DOOM, GLOOM, AND WISHFUL THINKING: THE
BUSINESS COMMUNITY REACTS TO GEORGIA

Classified By: CDA Eric S. Rubin, for Reasons 1.5 (b) and (d).

Summary

¶1. (C) The Russian markets ticked up slightly August 12, with news that President Medevev had ordered military operations in Georgia to cease and with French President Sarkozy's mediation efforts appearing to gather steam. However, the markets are down over 30 percent from their mid-May peak, a loss of some $400 billion in share-holder value, much of it in the past few weeks. The conflict in Georgia was just the latest blow to investor confidence, following hard on the heels of the TNK-BP investor dispute and the GOR attacks on steelmaker Mechel. Our contacts differed on where the markets are headed, with the key variables the length and intensity of the conflict and international and Western reaction. End Summary.

Markets React

¶2. (SBU) As the conflict began on Friday, August 8, Russia's "blue chip" RTS stock market index fell 6.5 percent to the lowest level since November 2006, and the broader MICEX fell 5.3 percent. When the markets reopened on August 11, both indices initially fell precipitously before recovering in the afternoon on hopes that the conflict might be easing. On Tuesday, both markets again rallied following Medvedev's announcement on the cessation of the military operation and on hopes that the French mediation would bring the conflict to an end. However, markets were lower again on Wednesday, reflecting continued anxieties.

¶3. (SBU) The conflict also precipitated a mini-liquidity crisis in the banking system and foreign exchange markets. Since August 8, the ruble has depreciated more than four percent against the dollar/Euro basket. Analysts noted that the Central Bank had allowed the ruble to depreciate by more than two percent on August 11, primarily to ease further liquidity pressures. The Finance Ministry also announced August 11 that it would supply up to RUB 300 billion, by auctioning temporarily available budget funds to banks on August 12, to further ease liquidity problems.

Doom and Gloom

¶4. (C) Merrill Lynch's Moscow Head of Global Trading, Bernie Sucher, an Amcit active in Russia since 1991, told us August 11 that the appetite for Russian equities was gone for now. Turmoil in the global markets had begun the downward trend in

mid-May but a series of unfortunate events within Russia, of which the Georgian conflict was merely the latest, had accelerated the decline. Medvedev's signing of the decree in May transferring billions of dollars in state assets, to Rosteknologia had been the first blow. This decision had been completely at odds with Medvedev's rhetoric concerning state corporations and the need to reduce their role in the economy. Investors had come away concerned that the "property redistribution phase" of Russian governance had not in fact ended.

¶5. (C) Sucher said the dispute over TNK-BP and the Mechel incidents had been the next blows. He discounted TNK-BP somewhat, noting everyone knew foreign investment into the oil and gas sector was dicey and so the markets had already priced in such a dispute. Mechel, however, had been a deeply unpleasant surprise to Russian and foreign investors, with its confirmation that no investment was safe from government insiders and that the government was prepared to use administrative means to intervene in the markets to control prices as well as to seize assets. Sucher said he had been surprised by the degree to which the Mechel incident had unnerved his Russian friends and clients. In particular, they had pointed to the extreme language Putin had used in his public attacks, which had been similar to the language he had used toward Chechen separatists.

¶6. (C) Sucher said taken together the incidents had been a nasty reminder of the fundamental reality in Russia: that government insiders controlled the commanding heights of the economy and were not about to allow that to change. Sucher added that longer-term, without clear contract and property rights, it would be impossible for the Russian economy to

modernize, become more competitive, and sustain growth. What Mechel had driven home was the growing loss of confidence among investors in the Medvedev government's promises of reform and increased economic freedom and transparency. Absent those reforms, Sucher said he could foresee a moment in the not too distant future when the Russian elite would have to make a choice between their ability to deliver rising living standards for the people and their own personal greed.

¶7. (C) Sucher said this shift in investor sentiment and the reasons for it were critical to understanding the economic reaction to the conflict in Georgia. Georgia itself was unimportant to the Russian economy but the conflict had reinforced the sense that economic considerations were secondary for the GOR and that made investors very nervous. If the conflict ended quickly and proved to be a limited event, he predicted the markets would recover somewhat. However, if the conflict persisted or if it led to a protracted cold spell in relations with the West, then all bets were off.

¶8. (C) Deutsche Bank Securities Chief Economist Yaroslav Lissovolik also told us the conflict had strengthened the hand of hard-liners in the GOR at the expense of the economic liberals. He noted that Deutsche Bank had been warning investors for the past two years that the main geopolitical risk in Russia was regional conflicts with Georgia and Ukraine that could shift the balance of power toward Kremlin hard-liners. With the hand of the "siloviki" now strengthened, needed reforms in the tax, pension, and health care systems, and the need for WTO entry, would no longer be GOR priorities this year.

¶9. (C) Lissovolik added that at least $8 billion initially flowed out of Russia on August 8 on the foreign exchange markets and the capital outflow then spread to the stock markets. He expected the capital outflows to continue this week, with long-term institutional investors likely to pull out of the Russian stock market if the conflict was prolonged. Lissovolik predicted that even if the conflict ended quickly, it was likely to cause a loss in annual GDP, albeit a small drop from the current robust levels of better than seven percent.

¶10. (C) Igor Nikolayev, Strategic Analysis Director for the business consulting firm FBK, told us that he also believed the conflict would cause a decline in annual GDP. The conflict was yet another negative factor in the context of high inflation, a lack of meaningful competition in many economic sectors, and the gloomy investment climate stemming from the recent administrative pressures on TNK-BP and Mechel. In particular, the military conflict, coupled with the TNK-BP and Mechel incidents, would contribute to a decline in international investment in Russia. Given all of the negative factors, he said that FBK had revised its forecast for real GDP growth downward to six percent for the year.

Wishful Thinking

¶11. (C) Renaissance Capital's Deputy Chairman, Bob Foresman told us the company's official position, dictated by CEO Steven Jennings, was that the Georgian conflict would have no long-term adverse effect on the Russian economy. Russia's economic fundamentals were still strong and Russian equities were priced too low. In addition, he said they expected the TNK-BP and Mechel situations to be resolved in the near future, setting the stage for a fall rally in the markets. Foresman cautioned that his own view was less bullish. Russia was not the "safe haven" that it had seemed a few months ago. Political and economic stability had weakened and the perception of risk, and therefore its price, had risen. It appeared that the markets might be reassessing the value of Russian equities.

¶12. (C) Foresman's colleague, Roland Nash, the head of Rencap's Research Department, said the result of that downward assessment had been a roughly 30 percent drop in the value of Russian equities since their high point in mid-May. Market capitalization had dropped from $1.6 trillion to $1.2 trillion, a loss of $400 billion in share holder values. Much of that loss had come in the past few weeks. Nash said Rencap still felt that Russia was the best of the emerging markets and the one most likely to weather any global downturn. The lower the markets went now, the higher they would bounce back later in the year when stocks rallied. Nash acknowledged that the conflict in Georgia could affect that calculus if it continued or if the West responded in ways that would raise the cost of capital in Russia, but he hoped that would not be the case.

¶13. (C) Goldman Sachs Executive Research Director Rory MacFarquhar also told us that he thought the conflict with Georgia would be a "blip" for Russia's economy. He expected military operations to be wrapped up quickly, especially following Medvedev's August 11 statement. Moreover, MacFarquhar doubted that concerns about South Ossetia would derail any planned foreign direct investments and posited that weeks of stock market selloffs had probably priced Russian markets into an acceptable range for investors who might have previously thought Russian stocks were overvalued.

Comment

¶14. (C) Russia's economic rough patch got a lot rougher this week. Even the most optimistic investors appear to be hedging their bets, with the real concern not so much the conflict in Georgia itself but what it might mean for Russia's relations with the West, its place in the global economy, and the prospects for badly needed domestic reforms.

RUBIN